



STATE OF MICHIGAN

JENNIFER M. GRANHOLM  
GOVERNOR

OFFICE OF THE STATE BUDGET  
LANSING

MARY A. LANNOYE  
DIRECTOR

December 28, 2005

The Honorable Jennifer M. Granholm, Governor  
Members of the Legislature  
People of the State of Michigan

As required by Article 9, Section 21, of the State Constitution and Section 494, Public Act 431 of 1984, as amended, we are pleased to submit the *State of Michigan Comprehensive Annual Financial Report* (SOMCAFR) for the fiscal year ended September 30, 2005.

**INTRODUCTION TO THE REPORT**

**Responsibility:** The Office of the State Budget, Office of Financial Management, prepares the SOMCAFR and is responsible for both the accuracy of the data and the completeness and fairness of the presentation, including disclosures. To the best of our knowledge and belief, the information contained in the SOMCAFR is accurate in all material respects and reported in a manner that fairly presents the financial position and results of operations of the State primary government and component units for which it is financially accountable. All disclosures necessary to enable the reader to gain a reasonable understanding of the State's financial affairs have been included.

**Adherence to Generally Accepted Accounting Principles:** As required by State statute, we have prepared the financial statements contained in the SOMCAFR in accordance with generally accepted accounting principles (GAAP) applicable to state and local governments, as promulgated by the Governmental Accounting Standards Board (GASB). The State also voluntarily follows the recommendations of the Government Finance Officers Association of the United States and Canada (GFOA) for the contents of government financial reports, and participates in the GFOA's review program for the Certificate of Achievement for Excellence in Financial Reporting.

**Report:** The SOMCAFR is divided into three major sections: introductory, financial, and statistical:

- The introductory section includes this letter, the State's organization chart, and the list of principal officials.
- The financial section includes: the independent auditor's report on the Basic Financial Statements; Management's Discussion and Analysis (MD&A) which provide an introduction, overview, and analysis to the Basic Financial Statements; the Basic Financial Statements, which present the government-wide financial statements and fund financial statements for governmental funds, proprietary funds, fiduciary funds, and component

units, together with footnotes to the Basic Financial Statements; Required Supplementary Information other than MD&A, which presents budgetary comparison schedules and information about infrastructure assets; and the supplemental financial data which includes the combining financial statements and schedules.

- The statistical section includes such items as trend information, information on debt levels, and other selected economic and statistical data.

**Internal Control Structure:** The Office of the State Budget is responsible for the overall operation of the State's central accounting system and for establishing and maintaining the State's internal control structure. The system of internal control has been designed to provide reasonable rather than absolute assurance that the financial statements are free from material misstatement.

All financial transactions of the State primary government are recorded in the central accounting system, except for the Michigan Unemployment Compensation Funds, Attorney Discipline System, the State Employees' Deferred Compensation Funds, the State Employees' Defined Contribution Retirement Fund, and the Michigan Education Savings Program. Many of the essential control features are decentralized, such as the preparation and entry of expenditure transactions into the central accounting system. Consequently, the Office of the State Budget relies upon the controls in place at the various State departments and agencies.

The Management and Budget Act requires each principal department to appoint an internal auditor and to maintain adequate internal control systems. Each department is also required to periodically report to the Governor on the adequacy of its internal accounting and administrative control systems and, if any material weaknesses exist, to provide corrective action plans and time schedules for addressing such weaknesses. This reporting is required on or before May 1 of each odd numbered year, effective as of the preceding October 1.

The discretely presented component units generally operate outside the State's central accounting system and are responsible for establishing and maintaining their own separate internal control structures.

**Independent Auditors:** The Office of the Auditor General (OAG) is the principal auditor of the SOMCAFR. The OAG also relies on the opinions of outside public accounting firms, particularly for component unit financial statements (such as the Michigan State Housing Development Authority and 10 of the State's universities), the larger pension and other employee benefit trust funds, and the Unemployment Compensation funds. The purpose of the OAG's audit is to provide reasonable assurance that the Basic Financial Statements for the fiscal year ended September 30, 2005 are free of material misstatements. The OAG concluded that the Basic Financial Statements for the fiscal year ended September 30, 2005 are fairly presented in accordance with GAAP and issued unqualified opinions.

In addition to the annual audit of the SOMCAFR, the OAG also performs periodic financial statement and performance audits of the various State departments, agencies, and institutions of higher education. The Auditor General also has primary responsibility for conducting audits under the federal Single Audit Act of 1984. Pursuant to Michigan Public Act 251 of 1986, these audits are conducted biennially for applicable State departments, agencies and component unit authorities, and result in separately issued audit reports.

**Management's Discussion and Analysis (MD&A):** GAAP requires that management provide a narrative introduction, overview, and analysis to accompany the Basic Financial Statements in the form of MD&A. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

## **PROFILE OF THE GOVERNMENT**

Michigan was admitted to the Union as the 26<sup>th</sup> state in 1837. The State is governed under the Constitution of 1963, as amended.

**Executive Branch:** The Executive Branch consists of 19 principal departments. Sixteen principal departments are headed by commissions and/or directors appointed by the elected governor. Two principal departments, Attorney General and State, are headed by elected officials and one, Education, is headed by an elected board.

**Judicial Branch:** The Judicial Branch consists of the Supreme Court, Court of Appeals, Court of Claims, and the State's circuit, district, probate, and municipal courts. In addition to its judicial duties, the Supreme Court is responsible for the general administrative supervision of all courts in the State. The Supreme Court also establishes rules for practice and procedure in all courts.

**Legislative Branch:** The Legislative Branch consists of the Senate, House of Representatives, and Office of the Auditor General. The Senate, which consists of 38 elected members, and House of Representatives, which consists of 110 elected members, enact the laws of Michigan. The Office of the Auditor General conducts post financial and performance audits of state government operations.

**Reporting Entity:** The financial reporting entity of the State includes all of the funds of the primary government as well as component units for which the State's elected officials are financially accountable. The transmittal letter,

MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

**Budgetary Reporting and Control:** For the State primary government operating funds (i.e., the General Fund and annually appropriated special revenue and permanent funds), the State budgets projected revenues and expenditures and calculates fund balance for budgetary purposes in accordance with GAAP. Public Act 431 of 1984, as amended, prohibits the State from budgeting for an ending fund balance deficit in an operating fund. If an actual deficit is incurred, the Constitution and Act 431 require that it be addressed in the subsequent year's budget. If accounting principles change, Act 431 requires the State to also implement such changes in its budgetary process.

Compliance with the final updated budget for the annually budgeted operating funds of the State primary government is demonstrated in the budget and actual comparative schedules and notes in the SOMCAFR. In addition, subsequent to the publication of the SOMCAFR, the State releases "Statewide Authorization Dispositions", a report providing line item appropriation details, the legal level of budgetary control, for the General Fund and budgeted operating funds.

## **ECONOMIC CONDITIONS AND OUTLOOK**

**U.S. Economy:** The U.S. economy continues to post solid growth. Over the first eleven months of 2005, employment has risen by an average of 167,000 jobs per month. Monthly U.S. employment now exceeds its pre-recession peak by 1.7 million jobs. Manufacturing employment, however, remains well below its peak – down by nearly one-fifth.

After growing by an estimated 3.6 percent in 2005, real gross domestic product is forecast to grow 3.0 percent in 2006. Light vehicle sales are expected to remain relatively steady with sales estimated at 17.0 million units in 2005 and 16.8 million units in 2006. Unemployment, estimated at 5.1 percent for 2005, is projected to remain at that rate for 2006. The growth in consumer prices, as measured by the consumer price index, is expected to slow slightly from 3.2 percent in 2005 to 3.0 percent in 2006.

**Michigan Economy:** Michigan's economy relies heavily on the performance of the manufacturing sector, in general, and the auto industry, specifically. As a result, Michigan economic growth has lagged behind U.S. economic growth.

For 2005, Michigan employment is estimated to have declined by 13,000 jobs (0.3 percent) – the fifth straight year that employment has declined. From Michigan's employment peak in June 2000, Michigan has lost approximately 330,000 jobs. However, there are signs that the Michigan labor market may be improving. Through November 2005, state employment has increased in three of the past four months.

Personal income was up an estimated 4.6 percent and wages and salaries income was up an estimated 3.0 percent in 2005. Both exceeded the increase in consumer prices, as measured by the Detroit consumer price index, which is estimated at 2.7 percent for 2005.

With continued U.S. economic growth, smaller declines in manufacturing sector employment, and improvements in the private non-manufacturing sector, Michigan employment is expected to grow 0.5 percent in 2006, with employment gains averaging about 5,000 jobs per quarter. Michigan personal income and wages and salaries income are projected to rise 5.3 percent and 4.1 percent, respectively, in 2006. Consumer prices are projected to increase 2.5 percent.

## **MAJOR INITIATIVES AND FUTURE PROJECTS**

**Education:** The State is committed to providing a quality education to all age levels. There are over 160 activities in 12 state departments that support the student achievement goal. Over \$14.9 billion, or 36.2 percent, of the State's total FY 2005-2006 budget is devoted to education. This includes funding for child-care and early childhood learning, K-12 education, support for colleges and universities, higher education financial assistance and adult learning opportunities.

The State continues to place emphasis on learning in the critical preschool years by investing in programs that provide quality early childhood learning, childcare, and parental education. The State has also instituted a program to identify and assist schools that are considered high priority for improvement in academic achievement.

**Economy:** State government is committed to growing its economy by sustaining and creating business investment and jobs in Michigan. In FY 2005-2006, the State has created the 21<sup>st</sup> Century Jobs for Michigan Fund, which will invest more than \$2 billion to create thousands of new jobs and diversify the State's economy. The fund will be used to invest in new technologies that will drive Michigan's economy into the future, with the focus on four high-growth areas: the life sciences, advanced manufacturing, alternative energy, and homeland security. In addition, the State has accelerated more than \$600 million in needed road and infrastructure building projects, which will put some 11,000 citizens to work over the next five years.

The State has also provided significant tax relief for businesses. Starting in FY 2005-2006, the tax cuts are expected to save businesses roughly \$600 million over the next four years. The tax cuts are designed to provide immediate relief to Michigan's struggling automotive and manufacturing industry and to make Michigan more attractive to future investors.

**Health and Human Services:** For Michigan to be a great place to live and work, Michigan must protect the health of its citizens and strengthen families. Cash assistance, social services, and medical services are provided to low-income families, children and individuals to preserve and strengthen Michigan's social safety net. Public health programs and prevention services are available to encourage and support healthy behavior and positive health outcomes. For FY 2005-2006, the two departments primarily responsible for health and human services, the Department of Community Health and Human Services, account for \$14.8 billion, or 35.9 percent, of the overall State budget.

While the State administers a variety of health and human services programs, Medicaid is the most extensive, accounting for \$8.2 billion of the FY 2005-2006 budget.

These funds allow the State to provide health care services for over 1.4 million low-income citizens.

**Hometown Security:** Protection of Michigan's residents is a top priority and a core function of state government. The State will invest \$2.8 billion in FY 2005-2006 in protecting its citizens.

There are over 92 activities, in 12 departments that support the goal of protecting Michigan's citizens and communities. These range from street-level public safety programs at the Department of State Police, to military preparedness of the Michigan National Guard, to incarceration of the State's most dangerous felons.

**Environment:** State government is committed to the conservation, protection, management, use, and enjoyment of the State's natural resources for current and future generations. Michigan has 11,000 inland lakes, 36,000 miles of rivers and streams, and 3,000 miles of freshwater shoreline. Numerous park and recreation areas enable Michigan's citizens and visitors to enjoy outdoor recreation in a fun and safe environment on public lands and waters while benefiting the economy. Michigan lands also yield several agricultural products which rank number one nationally in the State's second largest industry – agriculture production.

Efforts to enhance the quality of Michigan's natural environment encompass 195 activities in 6 departments, primarily activities performed by the Departments of Agriculture, Environmental Quality and Natural Resources who will spend approximately \$847.3 million in FY 2005-2006 on these efforts.

**Better Government:** Making government in Michigan more cost effective and efficient is a primary focus of state government. Better government in Michigan means keeping the budget balanced, providing fast and friendly service to all citizens, cutting red tape, and frugally managing the workplaces, tools and equipment of state government. It also means improving collaboration in order to increase efficiencies, making Michigan more equitable for all residents, and making state government a great place to work.

The State is undertaking a number of initiatives in FY 2005-2006 that will result in administrative efficiencies or cost savings. The largest of these include implementation of the Medicare Prescription Drug Benefit, which is expected to result in \$53.5 million in pension savings; procurement process improvements that are projected to save over \$30 million; and information technology changes that are expected to save over \$10 million.

## **AWARDS AND ACKNOWLEDGEMENTS**

**Certificate of Achievement:** The GFOA awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Michigan for its SOMCAFR for the year ended September 30, 2004. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report whose content satisfies both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The State has received a Certificate of Achievement for 18 consecutive years. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

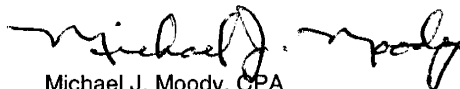
Acknowledgments: The preparation of this report requires the collective efforts of the management and staff of the Accounting and Financial Reporting Division, Office of

Financial Management; the chief financial officers, chief accountants, internal auditors and their staffs from all State agencies; and the management and staff of the Office of the Auditor General. We sincerely appreciate the dedicated efforts of all of these individuals that have allowed Michigan to maintain its position as a national leader in quality and efficiency for financial reporting.

Sincerely,



Mary A. Lannoye  
State Budget Director



Michael J. Moody, CPA  
Director, Office of Financial Management